



DEFENSE CONTRACT AUDIT AGENCY
AUDIT REPORT NO. 3311-2004K21000008



August 31, 2004

PREPARED FOR: Procuring Contracting Officer
U.S. Army Corps of Engineers
Fort Worth District
ATTN: Vernon Vann, Contract Specialist
819 Taylor Street, Room 2A19
Fort Worth, Texas 76102

PREPARED BY: DCAA Arlington Branch Office
Kellogg Brown & Root Suboffice
4100 Clinton Drive, Building 1, Room B-2
Houston, Texas 77020-6237
Telephone No. (713) 753-2167
FAX No. (713) 753-2919
E-mail Address dcaa-fao3318@dcaa.mil

SUBJECT: Report on Audit of Proposal for Restore Iraqi Oil Task Order No. 8

REFERENCES: Prime Contract No. DACA63-03-D-0005, Task Order No. 8
Relevant Dates: See Page 30

CONTRACTOR: Kellogg Brown & Root Services, Inc.
A Division of Kellogg Brown & Root, Inc.
4100 Clinton Drive
Houston, Texas 77020-6237

REPORT RELEASE RESTRICTIONS: See Page 31

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SUBJECT OF AUDIT

As requested by the U.S. Army Corps of Engineers (COE), on March 3, 2004, we examined the Kellogg Brown & Root Services, Inc.'s (KBR) Cost-Plus-Award-Fee task order (TO) 8 proposal, dated February 18, 2004, under the Restore Iraqi Oil (RIO) contract to determine if the proposed costs are acceptable as a basis to negotiate a fair and reasonable TO price. The \$180,000,000 proposal was submitted in response to the Notice to Proceed issued on January 30, 2004 and is for the import and distribution of fuel products in order to meet the domestic need for fuels for commercial and private use within Iraq. The company proposed a period of performance (POP) of 22 days or until funds are expended, whichever occurs first.

KBR's proposed costs, and the proposed Turkey and Jordan costs, are subject to cost and pricing data. In contrast, the proposed costs for the Kuwait supplier, Altanmia, were subject of a cost and pricing waiver granted by the Commanding General, COE, on December 19, 2003. As requested by Mr. Gordon Sumner, Director, Directorate of Contracting, COE, Southwestern Division on August 3, 2004, we evaluated the reasonableness of the refined fuels and related transportation from Kuwait that were subject to the waiver of the requirement to submit cost or pricing data. Refer to page 13 for additional comments regarding the waiver.

The proposal and related cost or pricing data are the responsibility of the contractor. Our responsibility is to express an opinion on the proposal based on our examination.

EXECUTIVE SUMMARY

[REDACTED] in an effort to meet the needs of the contracting officer, we evaluated the proposal to the extent possible under the circumstances and gathered data to support a negotiation position. Our examination of the \$180,000,000 proposal disclosed [REDACTED] of questioned costs. Our questioned costs are primarily based on reasonableness. [REDACTED]

SIGNIFICANT ISSUES:

1. The results of audit are qualified because we have not received the requested technical review of the proposed number and need for tanker trucks, Liquefied Petroleum Gas (LPG) barges, quantity of fuel, and a statement there was, or was not, a sufficient supply of fuel from Turkey and Jordan to justify the need for procuring fuel from Kuwait.
 2. The primary reasons for questioned material and subcontract costs are discussed below:
 - a. Proposed costs for the fuels procured from a Kuwait supplier (Altanmia) are based on May 2003 purchase orders negotiated in a very short time frame. [REDACTED]
- [REDACTED] We recognize the challenges faced by KBR

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during the early stages of the war; however, KBR did not update its purchase order files to document the reasonableness of the negotiated prices and the circumstances surrounding the purchase order awards within a reasonable period of time (e.g. initial purchase order issued May 2003 and Notice to Proceed on TO 8 issued January 30, 2004). Effective subcontract administration of purchase order files requires ongoing (e.g. monthly) documented reviews of the continued reasonableness of the Kuwait fuel prices and efforts to renegotiate these prices if such reviews indicated unreasonable prices. [REDACTED]

[REDACTED] We only found two instances where KBR renegotiated some of the prices. In November 2003 and January 2004, KBR negotiated some reductions to the pricing for the Kuwait fuel transportation costs. However, KBR's purchase order files do not include documentation to demonstrate these updated transportation prices were fair and reasonable. [REDACTED]

In the absence of adequate supporting data, we explored alternative methods to evaluate the reasonableness of the Kuwait fuel prices. We found the Defense Energy Support Center (DESC) awarded purchase orders in March 2004 to Altanmia for transportation and the KPC for unleaded fuel and diesel. We used the DESC negotiated prices as a benchmark to assess reasonableness of the proposed KBR costs and questioned [REDACTED]. Refer to Note 5, page 10 for further details.

b. KBR failed to use the correct purchase order change orders for the Turkey purchase orders. We have incorporated the change orders signed before the estimated POP, and questioned costs of [REDACTED]. Refer to Note 5, page 18 for further details.

c. We question the entire costs proposed for "subcontractor claims" and "demurrage costs" which totals [REDACTED]. KBR did not provide a breakout of these costs between what was proposed as "subcontractor claims" and "demurrage" costs. Based on our review of the data presented by KBR, we determined all of the demurrage costs incurred by KBR were incurred under TOs 5 and 7. As a result, demurrage costs should not be proposed under TO 8. Since KBR has not been able to identify or support proposed "subcontractor claims" costs, we question these costs as they represent contingencies which "should be excluded from cost estimates" in accordance with FAR 31.205-7 (c) (2). KBR did not separately identify these costs and the basis of estimate as required by FAR. Refer to Note 5, page 19 for further details.

d. We question the entire costs proposed for "LPG cancellation fees" which totals [REDACTED]. Since KBR has not been able to identify or support proposed "LPG cancellation fees," we question these costs as they represent contingencies which "should be excluded from cost estimates" in accordance with FAR 31.205-7 (c) (2). Normally, termination proposals are submitted separately from proposals to definitize contracts or TOs.

e. We question [REDACTED] of proposed subcontractor DBA insurance. Although DBA insurance is a requirement resulting from the Defense Base Insurance Act, we question these costs because (i) KBR did not provide any support for amounts proposed for subcontractors, and

(ii) we would expect such costs would have already been included in subcontractor estimates. Absent any support to the contrary, it appears the proposed costs duplicate costs already included in negotiated subcontracts. Refer to Note 6, page 20 for further details.

3. As of July 31, 2004, recorded direct costs on TO 8 have exceeded proposed costs by [REDACTED]. Specifically, KBR proposed direct costs of [REDACTED] while [REDACTED] was charged to the RIO 8 Job Cost Ledger as of July 31, 2004. KBR's proposal does not include any recorded costs. KBR is currently analyzing the validity of all RIO transactions and expects to make significant adjustments to all RIO TOs upon completion of its analysis. Any analysis and consideration of recorded costs during negotiations should include the impact of these adjustments to ensure accuracy of the cost information. Refer to pages 4 and 5 for further details.

SCOPE OF AUDIT

Except for the qualification described below, we conducted our examination in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the examination to obtain reasonable assurance that the proposal is free of material misstatement. An examination includes:

- evaluating the contractor's internal controls, assessing control risk, and determining the extent of audit testing needed based on the control risk assessment;
- examining, on a test basis, evidence supporting the amounts and disclosures in the proposal;
- assessing the accounting principles used and significant estimates made by the contractor;
- evaluating the overall proposal presentation; and
- determining the need for technical specialist assistance.

We evaluated the proposed costs using the applicable requirements contained in the:

- Federal Acquisition Regulation (FAR),
 - Defense FAR Supplement (DFARS), and
 - Cost Accounting Standards.
- [REDACTED]
- [REDACTED]

[REDACTED]

The scope of our examination reflects our assessment of control risk and includes audit tests designed to provide a reasonable basis for our opinion.

QUALIFICATION

On March 22, 2004, we requested a technical evaluation from the COE to determine the reasonableness of the number and need for tanker trucks and LPG barges, the quantity of fuel, and a statement there was or was not a sufficient supply of fuel from Turkey and Jordan to justify the need for procuring fuel from Kuwait. On April 14, 2004, Mr. Vernon D. Vann, Contract Specialist, informed us a technical evaluation would not be provided to us. We consider the technical analysis to be essential for our results of audit. Accordingly, the audit results are qualified to the extent additional costs could have been questioned based on a technical evaluation.

RESULTS OF AUDIT

In our opinion, except for the qualification discussed above, the cost or pricing data submitted by the offeror are inadequate in part (see comments on Exhibit A, Notes 2, 5, and 6 respectively for labor, fuel costs related to Jordan and Turkey, and other direct costs, respectively). However, the inadequacies described are considered to have limited impact on the subject proposal. The other than cost or pricing data submitted by the offeror are not adequate (see comments on Exhibit A, Notes 5 related to Kuwaiti fuel and transportation costs).

[REDACTED]

[REDACTED] we evaluated the proposal to the extent possible under the circumstances and gathered data to support a negotiation position. However, the technical evaluation described above is significant enough to materially impact the results of audit. Therefore, as discussed with Mr. Vann by Stephanie Casey, Auditor, on March 22, 2004, we recommend that contract price negotiations not be concluded until the results of the technical evaluation are considered by the contracting officer.

Recorded Costs

As of July 31, 2004, recorded direct costs on TO 8 have exceeded proposed costs by [REDACTED]. Specifically, KBR proposed direct costs of [REDACTED] while [REDACTED] was charged to the RIO 8 Job Cost Ledger as of July 31, 2004. KBR's proposal does not include any recorded costs. KBR is currently analyzing the validity of all RIO transactions [REDACTED]. Any analysis and

consideration of recorded costs during negotiations should include the impact of these adjustments to ensure accuracy of the cost information.

As part of our accounting system review, KBR disclosed it was in the process of performing a detailed analysis of RIO transactions, particularly fuel related transactions.

Since KBR has not reflected all adjustments in its official books and records, we are unable to perform our review of the correcting entries. KBR plans to complete its analysis and processing the adjusting journal vouchers in the near future. Our office plans to review adjusting entries when KBR's adjustments are completed.

Proposed Costs

Our examination of the \$180,000,000 proposal disclosed in questioned costs, as summarized below.

EXHIBIT A

<u>Contractor's Proposal & Results of Audit Review</u>				
<u>Cost Element</u>	<u>Proposed</u>	<u>Questioned Costs</u>	<u>Difference (Note 1)</u>	<u>Note</u>
Direct Costs				
Labor				2
Other Labor Related Cost (OLRC)				3
Equipment				4
Material				5
Subcontract				5
Other Direct Cost (ODC)				5
Subtotal of Direct Costs				6
Indirect Costs				
Overhead				7
Subtotal				
G&A				8
Facilities Capital Cost of Money				9
Total Costs				
Base Fee				
Award Fee				
Total Costs & Fee	\$ 180,000,000			

Explanatory Notes

1. The amounts in this column are presented solely for the convenience of the procurement activity in developing its negotiation objective. They represent only the arithmetic difference between the amounts proposed and questioned costs. You should not consider the amounts to be audit approved or recommended amounts. DCAA does not approve or recommend prospective costs because the amounts depend partly on factors outside the realm of accounting expertise, such as opinions on technical and production matters.

2. Labor

a. Summary of Conclusions:

We questioned [REDACTED] of labor costs primarily due to KBR proposing area differential and danger pay in excess of Department of State Standardized Regulations (DSSR), as of January 2004. Questioned costs are summarized as follows:

	Questioned Costs
Base Pay Changes	[REDACTED]
Area Differential & Danger Pay	[REDACTED]
Total	[REDACTED]

b. Basis of Contractor's Cost:

Labor hour calculations for the proposed employees are based on management estimates. [REDACTED]

In addition to basic pay, employees receive premiums such as foreign service bonus, area differential, and danger pay based on their locations. KBR proposed area differential and danger pay rates of [REDACTED] percent for Kuwait and between [REDACTED] and [REDACTED] percent for Jordan and Turkey [REDACTED]. Labor rates used in this proposal are the actual labor rates presented currently being paid by KBR; [REDACTED]

The Home Office Support and Closeout Administrator rates are based on an average of employee rates that perform jobs under these job classifications. KBR stated the rates are within the company's established salary grade range for the positions and are in line with pay rates of other employees performing like functions in support of this contract.

R&R is based on [REDACTED] employment agreements which states, "Employees are eligible for 14 days paid leave and travel after working 12 weeks at site."

c. Audit Evaluation:

[REDACTED] We asked for the rationale underlying why these costs are proposed as direct labor

rather than subcontracts for inter-company costs. [REDACTED]

We questioned [REDACTED] of area differential and danger pay which is in excess of the January 2004 Department of State Standardized Regulations (DSSR) for area differential and danger pay. KBR proposed [REDACTED] percent for area differential and danger pay for Kuwait and between [REDACTED] and [REDACTED] percent for Jordan and Turkey. According to the DSSR, as of January 2004, area differential and danger pay for Kuwait is 15 percent of employees' base pay and area differential for Turkey and Jordan is 10 percent (there is no danger pay for Turkey and Jordan). In addition, we questioned [REDACTED] of labor costs because the actual Closeout Administrator rate is higher, and the Home Office Support rate is lower, than the proposed rates.

d. Contractor's Reaction:

KBR did not provide any comments concerning factual matters regarding area differential and danger pay and labor rates.

3. OLRC

We compared the proposed burden and benefit rates to the Forward Pricing Recommended Rates (FPRR) dated [REDACTED] and found no significant differences.

4. Equipment

Due to the insignificance of the individual equipment costs we did not review the proposed costs.

5. Material and Subcontract Costs

a. Summary of Conclusions:

We questioned [REDACTED] of material and subcontract costs primarily due to:

[REDACTED]

Proposed and questioned costs are summarized as follows:

	Proposed	Questioned
Material	[REDACTED]	[REDACTED]

Subcontracts

b. Basis of Contractor's Cost:

The Kuwaiti proposed fuel and transportation costs are based on five purchase orders dated between August 2003 and November 2003. These purchase orders include the same pricing as the initial May 2003 purchase orders that were negotiated in a very short time frame. The Kuwaiti transportation costs are based on a monthly rental fee, independent of the number of trips and fuel costs are based on a unit price per liter. The Turkey proposed fuel costs are based on twelve purchase orders dated between May and December 2003. KBR issued change orders to cover this TO. The proposed Jordan subcontract costs are based on the contractual agreement between KBR and [REDACTED] issued January 26, 2004. KBR did not provide the basis for estimates, including calculations, for the proposed costs for subcontractor claims and demurrage.

c. Audit Evaluation:

The following is a schedule of the material and subcontract costs:

<u>Material Costs</u>	<u>Proposed</u>	<u>Questioned</u>	<u>Note</u>
Kuwait - Unleaded Gasoline	[REDACTED]		(1)
Kuwait - Diesel	[REDACTED]		(1)
Kuwait - Kerosene	[REDACTED]		(1)
Kuwait - LPG	[REDACTED]		(1)
Other	[REDACTED]		(2)
Total Material Costs	[REDACTED]		
<u>Subcontract Costs</u>			
Kuwait Transportation - Unleaded Gasoline	[REDACTED]		(1)
Kuwait Transportation - Kerosene	[REDACTED]		(1)
Kuwait Transportation - Diesel	[REDACTED]		(1)
Kuwait Transportation - LPG Barge	[REDACTED]		(1)
Total Kuwait Subcontract Costs	[REDACTED]		
Total Kuwait Material & Subcontract Costs		[REDACTED]	(1)

<u>Subcontract Costs</u>	<u>Proposed</u>	<u>Questioned</u>	<u>Note</u>
Turkey - Unleaded Gasoline			(3)
Turkey - Diesel			(3)
Turkey - Kerosene			(3)
Turkey - LPG			(3)
Total Turkey Subcontract Costs			(3)
Jordan - Diesel			(4)
Jordan - Kerosene			(4)
Total Jordan Subcontract Costs			
Subcontractor Claims & Demurrage			(5)
LPG Cancellation Fees			(6)
Other			(2)
Total Subcontract Costs			
Total for Material & Subcontract Costs			**

** The break-out of the total questioned costs of [REDACTED] is [REDACTED] for material costs and [REDACTED] for subcontract costs. Details of these calculations will be provided during negotiations.

(1) Kuwaiti Material & Subcontract Costs

Proposed costs for the fuels procured from a Kuwait supplier (Altanmia) are based on May 2003 purchase orders that were negotiated in a very short time frame. [REDACTED]

[REDACTED] We recognize the challenges faced by KBR during the early stages of the war;

[REDACTED] We only found two instances where KBR renegotiated some of the prices. In November 2003 and January 2004, KBR negotiated some reductions to the pricing for the Kuwait fuel transportation costs. [REDACTED]

[REDACTED] We also did not find evidence KBR took action to renegotiate the fuel or transportation costs after January 25, 2004, when the KPC was willing to deal directly with KBR.

[REDACTED]

As an alternative, to determine the reasonableness of the prices, we evaluated the consent packages KBR provided to its ACO. These consent packages included a Request for Consent from KBR and a letter from the ACO granting KBR approval to enter into or extend the contract with the subcontractor. The Request for Consent included the type of subcontract, a list of previous change orders, and the process KBR used to select the subcontractor.

[REDACTED]

[REDACTED]

We found the DESC awarded purchase orders in March 2004 to Altanmia for transportation and the KPC for unleaded fuel and diesel. We used the DESC negotiated prices as a benchmark to assess reasonableness of the proposed KBR costs and questioned [REDACTED].

The following is a schedule, showing the calculations, of the questioned costs for Kuwaiti fuel and transportation:

<u>Contract No.</u>	<u>Proposed Number of Units</u>	<u>Proposed Unit Price (Liter)</u>	<u>Audit Recommended Unit Price*</u>	<u>Difference in Unit Price</u>	<u>Questioned Costs</u>
Unleaded Fuel					
RIO-JIK-PO-3129	58,114,000	[REDACTED]			
RIO-JIK-PO-S0164 (Transportation)		[REDACTED]			
Subtotal		[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]
Diesel Fuel					
RIO-JIK-PO-2893	6,000,000	[REDACTED]			
RIO-JIK-PO-S0164 (Transportation)		[REDACTED]			
Subtotal		[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]
Kerosene					
RIO-JIK-PO-2893	40,114,000	[REDACTED]	[REDACTED]		
RIO-JIK-S0138 (Transportation)		[REDACTED]	[REDACTED]		

Subtotal

Total Questioned Costs

\$12,790,728

*Audit recommended price includes fuel and transportation costs.

We questioned [REDACTED] of fuel and transportation costs based on the information KBR provided and information obtained from outside sources to determine the reasonableness of the proposed prices per liter. Using DESC negotiated fuel prices as a benchmark for reasonableness as discussed below, we computed audit recommended prices per liter and questioned the difference between the proposed and our recommended prices.

[REDACTED], we have, as an alternative evaluation technique, compared the proposed prices to recently negotiated prices used by DESC. DESC has three contracts consisting of the purchase of fuel from KPC (Contract No. SP0600-04-0491), transportation services from Altanmia (Contract No. SP0600-04-D-0492), and management and oversight of the fuel operation from the Public Warehousing Company (Contract No. SP0600-04-C-5418). Below is a table summarizing the audit recommended liter prices of the fuel using prices negotiated by DESC adjusted by the Platt Pricing Index:

	Unleaded (Liter)	Diesel (Liter)	Reference
Weighted-Average Market Price	\$0.314	\$0.263	(a)
Transportation	0.111	0.111	(b)
Management & Oversight	0.002	0.002	(c)
Total Unit Price	<u>\$0.427</u>	<u>\$0.376</u>	

(a) Weighted-Average Market Price

DESC negotiated a price per liter with KPC and Altanmia in the February/March 2004 timeframe. The negotiated base fuel price varies with market prices as indexed with the Platts Pricing Index. For every half month period the pricing is based on the previous half month period. For example, the average Platts price for January 1 through 15, 2004 is \$0.291 per liter for unleaded gasoline. For fuel delivered during the time period of January 16 through 29, 2004, KPC will invoice DESC \$0.291 per liter. The Notice to Proceed was issued January 30, 2004, for 22 days; therefore, we estimated a POP from January 30 through February 20, or 22 days, and used a weighted-average price per liter developed from DESC prices in accordance with the Platts Pricing Index for the POP. Using unleaded fuel as an example, we computed the weighted-average market price using the estimated POP as shown below:

Unleaded Gasoline				
DESC - Platts Pricing Time Period	Audit Recommended POP	Platts	Liters Delivered	Cost
Jan 1 - 15	Jan 30 - 31	\$ 0.291	5,283,091	\$ 1,537,379
Jan 16 - 31	Feb 1 - 15	\$ 0.319	39,623,182	12,639,795
Feb 1 - 15	Feb 16 - 20	\$ 0.308	13,207,727	4,067,980
			<u>58,114,000</u>	<u>\$ 18,245,154</u>

Weighted-Average Price Per Liter \$ 0.314

Diesel				
DESC - Platts Pricing Time Period	Audit Recommended POP	Platts	Liters Delivered	Cost
Jan 1 - 15	Jan 30 - 31	\$ 0.243	545,455	\$ 132,546
Jan 16 - 31	Feb 1 - 15	\$ 0.265	4,090,909	1,084,091
Feb 1 - 15	Feb 16 - 20	\$ 0.264	1,363,636	360,000
			<u>6,000,000</u>	<u>\$ 1,576,637</u>

Weighted-Average Price Per Liter \$ 0.263

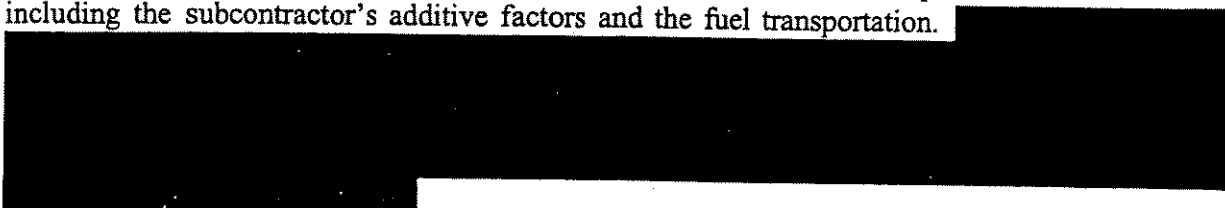
To compute the weighted-average price per liter we divided the audit recommended total cost by the total number of liters delivered.

(b) Transportation

Our recommended transportation price of \$0.111 per liter is based on the current DESC subcontract with Altanmia for three round trips (turns) per month.

KBR's procurement files do not include adequate documentation to justify the selection of other than the lowest bidder.

Our review disclosed that on May 4, 2003, KBR procured unleaded fuel including the subcontractor's additive factors and the fuel transportation.



(c) Management & Oversight

DESC negotiated a contract for management and oversight to provide services to distribute the imported fuel to the Iraqi civilian populace. In computing an audit recommended price we used the DESC contract rates as a benchmark for reasonableness.

Using the negotiated rates by DESC as a benchmark for reasonableness, we compared the proposed unleaded and diesel fuel and transportation costs to the current DESC contracts. We determined the proposed prices for unleaded gasoline and diesel and their transportation costs to be approximately ■ percent and ■ percent higher, respectively, than the DESC negotiated amounts. We believe these differences in prices are unreasonable. As a result, using the DESC negotiated prices adjusted by the Platt Pricing Index as a benchmark for reasonableness; we questioned the difference between the proposed fuel prices and the DESC negotiated prices as discussed above.

During our audit, we learned the COE waived KBR's requirement for submission of cost and pricing data on Contract No. DACA63-03-D-0005. The waiver from General Robert B. Flowers states,

"I have hereby determined that it is in the best interest of the United States Government to waive the requirement for cost and pricing data from Kellogg Brown and Root Services regarding its award of a subcontract for gasoline to Altanmia. By the authority delegated to me as the Head of the Contracting Agency, in accordance with FAR 15.403-1(c)(4), and upon reviewing the foregoing facts, authorities and analysis, I concur with the recommendation of my Contracting Officer and grant this Request for Waiver to Kellogg Brown and Root Services to exempt KBR from providing any cost and pricing data pertaining to its subcontract with Altanmia for the purchase of fuels under Task Orders 0005, 0007, and subsequent task orders involving the purchase of fuel under DACA63-03-D-0005."

On July 29, 2004, we issued a letter to the COE Director of Contracting requesting clarification on the waiver. Specifically, we requested clarification on whether a contracting officer determination had been made the costs proposed and incurred by KBR for Altanmia refined fuels and transportation are fair and reasonable. On August 3, 2004, COE Director of Contracting responded a DCAA audit was needed to assist in determining if KBR's proposed prices for Altanmia are fair and reasonable.

Our reading of the waiver does not relieve KBR of its responsibility to conduct a price analysis of the proposed Altanmia subcontract prices to demonstrate the reasonableness of the proposed subcontract prices. FAR 15.404-1(a)(2) states, "Price analysis shall be used when

cost or pricing data are not required." FAR 15.404-3(b), Subcontract Pricing Considerations, states, "The prime contractor or subcontractor shall...Conduct appropriate cost or price analysis to establish reasonableness of the proposed subcontract prices." Despite the waiver granted by the COE, KBR states the fuel and transportation procurement is competitively priced. [REDACTED]

[REDACTED] Our review of the documentation provided by KBR disclosed it had obtained vendor quotes on May 4, 2003, from three firms, with Altanmia being the lowest bidder. This information was communicated to the contracting officer who requested the Kuwait Oil Minister approve Altanmia as the subcontractor to provide fuel to Iraq. [REDACTED]

Additionally, in early May 2003, during a period of a few days, KBR obtained three supplier quotes and awarded a purchase order in the amount of [REDACTED] to Altanmia for unleaded fuel. [REDACTED]

Over the next several months, KBR made additional awards to Altanmia of over \$90 million for unleaded gasoline using the May 2003 price. [REDACTED]

[REDACTED] FAR 15.403-1(c) states,

(1) *Adequate price competition.* A price is based on adequate price competition if-

(i) Two or more responsible offerors, competing independently, submit priced offers that satisfy the Government's expressed requirement and if-

(A) Award will be made to the offeror whose proposal represents the best value (see 2.101) where price is a substantial factor in source selection; and

(B) There is no finding that the price of the otherwise successful offeror is unreasonable. Any finding that the price is unreasonable must be supported by a statement of the facts and approved at a level above the contracting officer;

(ii) There was a reasonable expectation, based on market research or other assessment, that two or more responsible offerors, competing independently, would submit priced offers in response to the solicitation's expressed requirement, even though only one offer is received from a responsible offeror and if-

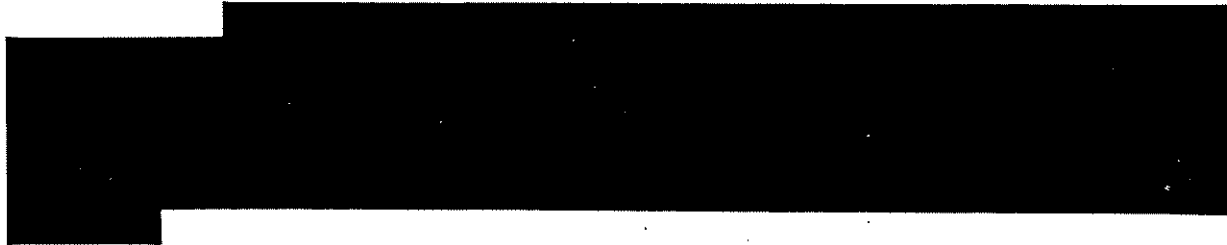
(A) Based on the offer received, the contracting officer can reasonably conclude that the offer was submitted with the expectation of competition, e.g., circumstances indicate that-

(1) The offeror believed that at least one other offeror was capable of submitting a meaningful offer; and

(2) The offeror had no reason to believe that other potential offerors did not intend to submit an offer; and

(B) The determination that the proposed price is based on adequate price competition, is reasonable, and is approved at a level above the contracting officer; or

(iii) Price analysis clearly demonstrates that the proposed price is reasonable in comparison with current or recent prices for the same or similar items, adjusted to reflect changes in market conditions, economic conditions, quantities, or terms and conditions under contracts that resulted from adequate price competition.



We believe the conditions surrounding the original procurement of Kuwaiti fuel under TO 5 (modified to extend to TO 7) changed substantially on January 25, 2004. We received a copy of a letter from KPC, dated January 25, 2004, addressed to a Procurement Manager for KBR. Based upon this letter, we understand KPC waived the requirement to negotiate directly with Altanmia upon the expiration of KBR's subcontract with Altanmia at the end of January 2004 due to the "recent uproar in the United States and Kuwait....regarding fuel overcharging." When asked why KBR did not subcontract with alternative vendors or renegotiate a lower price with Altanmia, the KBR Director of Government Compliance in a letter on June 3, 2004, stated the following:

"An informal suggestion was made by KPC, which did not include an offer with terms and conditions, was made on January 29, 2004, only days before the current contract was to expire on February 1, 2004. As a result, it would have been logistically impractical for KBR at that late date to have attempted to procure fuel directly from KPC. In contrast, KBR was under an existing contractual obligation with Altanmia for the provision of fuel, and had every expectation that the contract would be extended (as had prior contracts over the course of the procurement).

In addition, KBR understands that, at that time, KPC was selling fuel to Altanmia at floating spot market prices. In contrast, Altanmia was supplying fuel to KBR based on a fixed per-liter price that, by January 2004, was lower than the floating spot-market fuel price that KPC was charging Altanmia. We understand that, in January 2004, Altanmia was paying KPC \$405 per ton for benzene (\$0.091 KD or \$0.303 per liter). These prices had risen steadily from \$325 per ton in September 2003 because of the rising spot market. On the other hand, KBR was purchasing fuel from Altanmia at a fixed price of \$0.09 KD (\$0.30) per

liter. In addition, the floating price has continued to rise after January 2004 and by February 2004 had risen to \$407 per ton for benzene.

In addition, Altanmia was incurring administrative costs imposed by KPC of approximately \$20 per ton, which it could not pass on to KBR given the fixed-price nature of the fuel contract. Had KBR purchased fuel directly from KPC, it is likely that KBR would have incurred this additional administrative cost. Accordingly, it would not have been advantageous for KBR to have begun purchasing fuel from KPC on these terms.

Finally, with respect to transportation, Altanmia had amassed a substantial fleet of close to 1,900 trucks over the course of the previous fuel procurement. Given the overall shortage of trucks in Kuwait, KBR had no reason to believe that any other subcontractor could have begun to transport fuel beginning February 1, 2004, or had a realistic chance of meeting the USACE's fuel requirements."

KPC's letter to KBR releasing the requirement to contract only with Altanmia was dated, January 25, 2004. KBR had six days, from the date of the letter to the start of TO 8, to negotiate the procurement of fuel with KPC or alternate vendors. Rather than take advantage of these six days, KBR used basically the same purchase order prices negotiated in a short timeframe from nine months ago.

[REDACTED]

[REDACTED], KBR paid in excess of market prices, resulting in excessively high costs under the contracts with the Government. As for the administrative costs, if these costs would have been passed onto KBR, the result would have been approximately a two cent increase per liter (one ton equals 1,162.79 liters) $\$20 / 1,162.79 = \0.0172). If Altanmia would have charged KBR market prices for unleaded gasoline and passed on the administrative costs prior to the January/February time frame, the price per liter still would have been less than the purchase order fixed priced rate.

The comments made by the contractor's representative regarding the fact Altanmia had amassed a substantial fleet of close to 1,900 trucks over the course of the previous fuel procurement is misleading, we have no means of determining if another subcontractor could have put together a fleet of trucks to meet the transportation needs. KBR assumed no other subcontractor could amass a fleet of trucks as Altanmia had and it did not send out a request for proposals or contact any other subcontractors to determine if this was correct. Therefore, we are unable to determine if another subcontractor could have provided transportation services.

In summary, in our opinion, KBR had the opportunity after January 25, 2004, to renegotiate Kuwaiti fuel purchases but failed to act. Although the window of opportunity was short, there was enough time, as demonstrated in May 2003, when KBR made the initial award in a few days, to negotiate subcontracts with alternative vendors or renegotiate a lower price with Altanmia. As a result of KBR's failure to act in the purchase of Kuwaiti fuel when KPC waived the requirement to negotiate directly with Altanmia, the Government has paid unreasonable costs.

(2) Other Costs

We did not audit these costs due to immateriality.

(3) Turkey Subcontract Costs

Below is a summary of the questioned costs related to the Turkey fuel costs.

Contract No.	Proposed Liters/Metric Tons	Proposed Unit Price (Liter/Metric Ton)	Audit Recommended Unit Price* (Liter/Metric Ton)	Difference in Unit Price	Questioned Costs
Unleaded Fuel					
GU64-TURIO-S0005	14,342,414				
GU64-TURIO-S0006	33,561,645				
GU64-TURIO-S0007	33,561,645				
GU64-TURIO-S0031	11,258,623				
Subtotal					
Diesel Fuel					
GU64-TURIO-S0006	29,851,415				
GU64-TURIO-S0007	29,851,415				
Subtotal					
Contract No.	Proposed Liters/Metric Tons	Proposed Unit Price (Liter/Metric Ton)	Audit Recommended Unit Price* (Liter/Metric Ton)	Difference in Unit Price	Questioned Costs
Kerosene					
GU64-TURIO-S0025	26,396,293				
GU64-TURIO-S0026	26,396,293				
GU64-TURIO-S0027	26,396,293				
GU64-TURIO-S0030	8,541,976				
Subtotal					
LPG					
GU64-TURIO-S0003	6,361				
GU64-TURIO-S0008	12,721				
GU64-TURIO-S0011	6,361				
GU64-TURIO-S0016	6,361				
Subtotal					
Total Questioned Costs					

We questioned [REDACTED] of the Turkey fuel costs. KBR subcontracted with various Turkey vendors to deliver fuel into different parts of Iraq. It entered into Fixed-Unit-Rate and Firm-Fixed-Price contracts with these vendors. After the subcontract agreements were put into effect; the market price of the fuel increased. The Turkey subcontractors asked KBR to increase the unit price of the fuel to compensate for its losses due to the market increases. KBR

agreed to pay the vendors unit prices higher than the subcontracted agreement and issued change orders to increase the subcontract unit price. KBR's proposal did not take into account all of the change orders; therefore, we adjusted its proposal to reflect these changes. The Notice to Proceed was issued January 30, 2004, for 22 days; therefore, we estimated a POP from January 20 through February 20, or 22 days, and only applied change orders signed before that date. We did not apply the change orders signed after the start of the estimated POP because KBR's subcontract agreements are fixed and we do not believe these prices should be retroactively changed after the POP started.

We reviewed the Turkey subcontract files and found KBR contracted with the lowest bidder for the procurement and delivery of fuels from Turkey to Iraq. We also reviewed the change orders issued which changed the unit prices of the fuel and applied the correct change orders to the proposal. Based on the estimated POP, KBR did not use the correct change orders in its proposal for the unleaded gasoline, diesel, kerosene, and LPG fuels. We did not apply the change orders signed after the start of the estimated POP because KBR's subcontract agreements are fixed and we do not believe these prices should be retroactively changed after the POP started.

(4) Jordan Subcontract Costs (Diesel & Kerosene)

We take no exception to the proposed diesel and kerosene costs for the proposed Jordan subcontracts. KBR obtained five bids and selected the lowest bidder. We reviewed the Jordan subcontract files and found KBR contracted with the lowest bidder for the procurement and delivery of fuels from Jordan to Iraq. The subcontract was a Firm-Fixed-Price contract and the price of the proposed fuel did not change in the subcontract.

(5) Subcontractor Claims & Demurrage Costs

We questioned [REDACTED] in subcontractor claims and demurrage costs, KBR did not provide the basis of estimate, including calculations for these proposed costs. KBR also did not provide a breakout of these costs between what was proposed as subcontractor claims or demurrage costs. Based upon concurrent audit activity conducted by our office, we have determined all of the demurrage costs incurred by KBR were incurred under TOs 5 and 7. We received an e-mail from [REDACTED], KBR Government Compliance, on June 23, 2004, stating only TOs 5 and 7 received demurrage costs. He also stated of the demurrage invoices, two had not been identified with a TO. When we reviewed these invoices, we found the invoices were dated in 2003, indicating they could only be charged to TOs 5 or 7 since those were the only TOs worked on in 2003. In addition, we believe subcontractor claim costs should not be included in a proposal. [REDACTED]

[REDACTED] we question these costs as they represent contingencies which "should be excluded from cost estimates" in accordance with FAR 31.205-7 (c)(2).

(6) LPG Cancellation Fees

We question [REDACTED] in proposed LPG cancellation fees. Since KBR has not been able to identify or support proposed "LPG cancellation fees," we question these costs as they represent contingencies which "should be excluded from cost estimates" in accordance with FAR 31.205-7 (c) (2). Normally, termination proposals are submitted separately from proposals to definitize contracts or TOs.

d. Contractor's Reaction:

KBR did not provide any comments concerning factual matters during the exit conference. However, based on discussions and correspondence received during the audit, KBR does not concur with our position. Also, see the comments by the Director of Government Compliance starting on page 15 of this report.

e. Auditor's Response:

Our response to these comments is on page 17.

6. Other Direct Costs

a. Summary of Conclusions:

We questioned \$[REDACTED] of ODCs due to KBR proposing subcontractor DBA insurance because KBR did not provide any support and such costs would have been included in subcontractor estimates.

b. Basis of Contractor's Cost:

ODCs consist of costs for subcontractor DBA insurance, airfare and hotel costs associated with R&R, per diem costs for employees working in Kuwait, and cell phone charges.

For DBA Insurance KBR stated the proposed rate of [REDACTED] percent is an error and the proposed rate should be [REDACTED] percent. KBR also proposed the same rate for its subcontractors.

c. Audit Evaluation:

We questioned [REDACTED] in subcontractor DBA insurance costs. Although DBA insurance is a requirement resulting from the Defense Base Insurance Act, we question these costs because (i) KBR did not provide any support for amounts proposed for subcontractors, and (ii) we would expect such costs would have already been included in subcontractor estimates. We requested support for the proposed subcontractor DBA insurance costs and KBR stated it did not have the subcontractors' insurance policies and did not provide any billings indicating the subcontractors separately billed this cost to KBR. Since the DBA insurance is a requirement of the contract and absent any support to the contrary, it appears the proposed costs duplicate costs

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already included in negotiated subcontracts; therefore, we removed these costs from the proposal.

d. Contractor's Reaction:

KBR did not provide any substantive information to incorporate into this audit report during the exit conference.

7. Overhead

a. Summary of Conclusions:

We questioned overhead costs of [REDACTED]. Questioned costs result from rate and base differences.

b. Basis of Contractor's Cost:

The contractor's overhead is computed by applying a proposed December 5, 2003, FPRR rate [REDACTED] percent to total direct costs.

c. Audit Evaluation:

We compared the proposed overhead rate to the current July 29, 2004 FPRR rate of 0.50 percent. We computed the questioned overhead by applying the questioned [REDACTED] percent [REDACTED] to the proposed base to determine questioned costs due to the questioned rate. We also applied the current FPRR rate to the questioned base costs to determine questioned costs due to questioned base costs.

Questioned costs are computed as follows:

Costs Questioned Due to Rate:

Proposed Base	[REDACTED]
Questioned Overhead Rate [REDACTED]	[REDACTED]
Questioned Overhead due to Questioned Rate	[REDACTED]

Costs Questioned Due to Base:

Questioned Base	[REDACTED]
Current FPRR Overhead Rate	[REDACTED]
Questioned Overhead due to Questioned Base	[REDACTED]

Total Questioned Overhead	[REDACTED]
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d. Contractor's Reaction:

KBR acknowledged the use of the [REDACTED] FPRR should be updated to the [REDACTED] FPRR.

8. G&A

a. Summary of Conclusions:

We questioned G&A costs of [REDACTED]. Questioned costs result from rate and base differences.

b. Basis of Contractor's Cost:

The contractor's G&A is computed by applying a proposed [REDACTED] FPRR rate [REDACTED] percent to total direct and overhead costs.

c. Audit Evaluation:

We compared the proposed G&A rate from the [REDACTED] FPRR to the [REDACTED] rate of [REDACTED] percent. We computed the questioned G&A by applying the questioned [REDACTED] to the proposed base (direct costs and overhead) to determine questioned costs due to the questioned rate. We also applied the current FPRR rate to the questioned base to determine questioned costs due to questioned base and overhead costs.

Questioned costs are computed as follows:

Costs Questioned Due to Rate:

Proposed Base	[REDACTED]
Questioned G&A Rate [REDACTED]	[REDACTED]
Questioned G&A due to Questioned Rate	[REDACTED]

Costs Questioned Due to Base:

Questioned Base	[REDACTED]
Current FPRR G&A Rate	[REDACTED]
Questioned G&A due to Questioned Base	[REDACTED]

Total Questioned G&A	[REDACTED]
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d. Contractor's Reaction:

KBR acknowledged the use of the [REDACTED] FPRR should be updated to the [REDACTED] FPRR.

9. Facilities Capital Cost of Money (FCCM)

We compared the proposed FCCM rate to the FPRR dated [REDACTED] and took no exception. However, in questioning direct costs there are associated FCCM questioned costs; we have determined these costs to be insignificant.

Exit Conference:

We discussed factual matters concerning our findings with Ron Costello, Contracts; Nic Andrews, Government Compliance; Floyd Green, Government Compliance; and Ramesh Shah, Projects Contracts Manager; in an exit conference held on July 22, 2004. The factual matters discussed are detailed below.

- [REDACTED]
- KBR did not provide support or rationale for proposed LPG cancellation fees;
 - KBR did not provide supporting documentation for the subcontractor DBA insurance costs;
 - KBR did not use the current Turkey purchase order change orders as the basis of the proposed Turkey costs;
 - The proposal is not based on the current FPRR; and
 - Labor rates changed due to payroll information given to DCAA.

We did not provide the dollar impact of our findings. KBR did not provide any comments concerning factual matters. However, even though comments were not provided in the exit conference except for R&R, we expect KBR to pursue the differences relating to fuel prices, R&R labor and ODC, LPG cancellation fees, subcontractor claims and demurrage cost, and subcontractor DBA insurance at negotiations. Because we expect the contractor to contest certain significant issues raised in our audit, we recommend you invite a DCAA representative to attend the negotiations conference.

CONTRACTOR ORGANIZATION AND SYSTEMS

1. Organization

[REDACTED]

Based on the information we have, Halliburton's business is organized into two groups, the Engineering and Construction Group and the Energy Services Group (ESG). ESG includes four business segments – Drilling and Formation Evaluation, Fluids, Production Optimization, and Landmark and Other Energy Services. The Engineering and Construction Group (E&C) operates as KBR. This group provides engineering, procurement, construction, project management, facilities operation, and maintenance for oil and gas to industrial and Governmental customers.

In 2003 KBR transferred its U.S. Government contracts to Kellogg Brown & Root Services, Inc. (KBRSI), a division of KBR, and Halliburton provided a performance guarantee for the transferred contracts. KBRSI is responsible for performance of the Logistics Civil Augmentation Program (LOGCAP III), Restore Iraqi Oil (RIO) program, and Balkans support contracts. LOGCAP III with a ceiling of \$11.3 billion provides contingency/wartime logistics support to military and civilian personnel for more than 80 locations worldwide. RIO consists of two contracts. One for the rebuilding of Iraqi oil infrastructure with a contract value of \$2.6 billion and one for the restoration of southern Iraqi oil fields with a contract value of \$563 million. The Balkans support contract provides full logistic services to U.S. troops in the Balkans region. Halliburton has provided a corporate guarantee for the LOGCAP, RIO, and Balkans support contracts.

Halliburton revenues and personnel worldwide for prior fiscal years and projected revenues for FY 2004 are as follows:

	2004	2003	2002	2001
Total revenues (in millions)	\$15,216	\$16,271	\$12,572	\$13,046
U.S. Government sales	32%	26%	<10%	<10%
Personnel		101,000	83,000	85,000

2. Systems

a. Accounting System:

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

b. Billing System:

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

c. Estimating System:

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

d. Purchasing System:

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

DCAA PERSONNEL

	<u>Telephone No.</u>
Primary contacts regarding this audit:	
Stephanie M. Casey, Auditor	(303) 969-5000
Gary R. Catt, Supervisory Auditor	(713) 753-2548
Other contact regarding this audit report:	
William F. Daneke, Branch Manager	(817) 640-4948
Arlington Branch Office	<u>FAX No.</u>
	(817) 633-4280
Arlington Branch Office	<u>E-mail Address</u>
	dcaa-fao3318@dcaa.mil

General information on audit matters is available at <http://www.dcaa.mil>.

RELEVANT DATES

Request for Audit: PCO – Dated and Received March 3, 2004
Due date extended to July 16, 2004.

AUDIT REPORT AUTHORIZED BY:

/signed/

William F. Daneke
Branch Manager
DCAA Arlington Branch Office